

EMPLOYEE PLANS DETERMINATIONS QUALITY ASSURANCE BULLETIN

Part-Time Employees Revisited

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On November 22, 1994, the Employee Plans Division issued a field directive addressing "Exclusion of part-time employees from plan participation under Code section 410". This directive provided that the exclusion of part time employees (employees who work less than 40 hours per week) imposes an indirect service requirement on plan participation that could exceed one year of service. Plans which exclude such employees violate Code section 410(a) and section 1.410(a)-3 of the regulations.

On November 28, 2000 a Technical Advice Memorandum (TAM) was issued and forwarded to all EP managers regarding whether a plan's exclusion from participation of certain employees constitutes an indirect age or service requirement under IRC section 410(a).

In its analysis of the issue, the TAM concluded that the 1994 Field Directive does not apply to a consideration of a plan's indirect service requirements at the determination letter stage. Rather, the issue should be decided when the plan is examined by the Service. As a result of the TAM, the Publication 794 was revised in July 2001 to include the following statement:

A determination letter may not be relied on with respect to whether a plan's exclusion classifications, if any, violate the minimum age or service requirements of section 410 by indirectly imposing an impermissible age or service requirement.

Subsequent to the issuance of the TAM and prior to the revision of the Publication 794, specialists were instructed to begin including the caveat referenced in the TAM if the plan included exclusion classifications. The caveat ceased to be input on letters when the Publication was revised.

On September 6, 2002, the EP Determinations Quality Assurance Staff (QAS) issued guidance via a Recurring Issue Focus (RIF) document addressing the acceptability of plan language that excludes from plan participation those individuals who are classified as "part-time" employees.

The RIF concluded that based on the conclusion in the TAM issued November 28, 2000, specialists should not request plan administrators to remove or clarify plan language relating to part-time employees or other exclusions with indirect service related conditions.

LAW:

Section 410(a)(1) of the Code provides certain minimum participation standards. Section 410(a)(1) provides, in general, that a trust will not be qualified if the plan of which it is a part requires, as a condition of participation, that an employee complete a period of service with the employer maintaining the plan extending beyond the later of the date on which the employee attains the age of 21 or the date on which he completes one year of service (or two years of service in the case of a plan which satisfies section 410(a)(1)(B)(i) of the Code).

Section 410(b) of the Code provides certain minimum coverage requirements that were introduced in ERISA. Under section 410(b), a plan could satisfy these requirements by benefiting such employees that qualify under a classification set up by the employer that did not discriminate in favor of employees who are officers, shareholders, or highly compensated. Although the Tax Reform Act of 1986 (TRA 86) made significant changes in the coverage requirements of section 410(b) of the Code, it retained the concept of nondiscriminatory classifications. Section 410(b) now provides, in general, that a trust will not be qualified unless the plan of which it is a part benefits a minimum percentage of nonhighly compensated employees. One prong of the average benefit percentage test described in section 410(b)(2) of the Code, provides that if a plan benefits a reasonable classification of employees set up by the employer that is not found to be discriminatory in favor of highly compensated employees, then the plan has, in part, satisfied section 410(b).

Section 1.410(a)-3 of the Income Tax Regulations provides guidance on the minimum age and service conditions of section 410(a)(1) of the Code. Section 1.410(a)-3(d) of the regulations provides that the minimum age and service rules of the Code do not preclude a qualified plan from establishing conditions, other than conditions relating to age or service, which must be satisfied by plan participants. Section 1.410(a)-3(e)(1) of the regulations, however, provides that plan provisions may be treated as imposing age or service requirements even though the provisions do not specifically refer to age or service. Plan provisions that have the effect of requiring an age or service requirement with the employer or employers maintaining the plan will be treated as if they imposed an age or service requirement.

Section 1.410(a)-3(e)(2) of the regulations provides a number of examples illustrating this rule. In example (3), a plan, which requires one year of service as a condition of participation, also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or 5 months in any plan year. The example states that the plan does not qualify because the provision could result in the exclusion by reason of minimum service requirement of an employee who has completed a year of service. The example further states that the plan would not qualify even though, after excluding all such employees, the plan satisfied the coverage requirements of section 410(b).

ANALYSIS

The November 28, 2000 TAM provides that whether the plan provisions excluding the group of employees cited in the TAM "... have the effect of indirectly imposing a service requirement within the meaning of section 1.410(a)-3(e) of the regulations depends on an examination of all of the facts and circumstances present in the employer's workforce. Such an inquiry is time consuming, both for the Service as well as the taxpayer, particularly at the determination letter stage. Further, in this case we do not have the necessary demographic data and other relevant facts. For this reason, the question of whether a particular plan exclusion classification violates the minimum service requirements of section 410 of the Code by indirectly imposing an impermissible service requirement, should be decided when the plan is examined by the Service and not in connection with the issuance of a determination letter."

Whether a plan provision as written violates Code section 410(a) depends in large part on the definition provided for the exclusion classification. The Group A and Group B classification of employees excluded from participation in the plan addressed in the TAM were not defined with reference to service, i.e., the definitions for Group A and Group B did not include any mention of a particular number of hours of service. In this situation, the question of whether a plan's exclusion classification does in fact result in the improper exclusion of an employee and thus violates Code section 410(a) is, as stated in the TAM, best determined on examination.

However, as cited in the examples under the regulations, a plan provision will be treated as violating Code section 410(a) if the plan provision **could** result in the exclusion, by reason of a minimum service requirement, of an employee who has completed a year of service.

Prior to the issuance of the TAM, specialists were instructed, via the field directive issued on Nov. 17, 1994, to solicit clarifying or corrective language in cases where a plan defined an exclusion classification by reference to service. This is the issue we typically encounter with plans attempting to exclude part-time or seasonal employees. Part-time or seasonal employees are commonly defined as employees who are expected to work less than 1,000 hours of service during a plan year or employees who do not customarily work more than "x" number of hours per week. This is a service requirement that could result in the exclusion of an employee who may complete more than 1,000 hours of service, in violation of IRC 410(a)(1).

Specialists were advised to carefully scrutinize how a plan defined the groups to be excluded from participation. If the definition related to service, the issue was to be pursued and clarified/corrected.

CONCLUSION

Publication 794 states that a determination letter may not be relied on with respect to whether a plan's exclusion classifications, if any, violate the minimum age or service requirements of IRC section 410 by indirectly imposing an impermissible age or service requirement.

Regardless of the fact that a plan that receives a determination letter has no reliance with regard to its exclusion classifications, plan documents should not, in form, include language that imposes an indirect service requirement that **could** result in the exclusion of an employee that completes 1,000 hours of service.

While the TAM concludes that an examination of the plan is the most efficient method to determine if a plan's exclusion classification does in fact violate IRC 410(a)(1), the fact remains that the examples in Regulation 1.410(a)-3(e) clearly state that a plan that includes a provision that imposes an indirect service requirement that **could** result in the exclusion of an employee that completes 1,000 hours of service would fail to be a qualified plan.

Effective with the opening of the Pre-Approved Program and the Determination Letter Program for EGTRRA, the guidance in the Recurring Issue Focus issued on September 6, 2002 is rescinded. Specialists should again begin requesting that plan administrators remove or clarify plan language if a plan includes a provision that defines an exclusion classification by reference to service **and** the plan provision could result in the exclusion, by reason of a minimum service requirement, of an employee who has completed a year of service.

Specialists should take note that the issue of whether a plan is providing a direct or indirect service requirement is not limited to part-time or seasonal employees. Any exclusion classification, whether it be part-time, seasonal, temporary, or any other classification of employees, should be closely scrutinized. Specialists should require that any such classification be clearly defined.

If the plan defines an exclusion classification without reference to service, as is the case in the TAM cited above, the plan's exclusion classification should not be challenged.

Publication 794, revised July 2001, states that a determination letter may not be relied on with respect to whether a plan's exclusion classifications, if any, violate the minimum age or service requirements of IRC section 410 by indirectly imposing an impermissible age or service requirement. Plan sponsors that received a determination letter on or after July 1, 2001 that included impermissible service-related exclusion classifications are not entitled to retroactive relief under IRC 7805(b).

Plan sponsors that received a determination letter prior to July 1, 2001 that included impermissible service-related exclusion classifications may be entitled to retroactive relief under IRC 7805(b), unless the determination letter included a caveat indicating that the determination letter could not be relied upon with respect to the plan's exclusion classifications.

EXAMPLES:

The following examples are meant to provide clarification of when to solicit corrective language with regard to a plan's exclusion classification provisions.

Example 1:

Two plans, Plan A and Plan B, both provide for one year of service as a condition of participation. Both plans also provide that employees classified as part-time or seasonal employees shall not be eligible to participate in the plan.

Plan A defines a part-time or seasonal employee as an employee who works less than 1,000 hours of service in an eligibility computation period. Plan B defines a part-time or seasonal employee as an employee who is scheduled to work less than 1,000 hours of service in a year.

Plan A should not be challenged. Although Plan A provides an exclusion classification that references service, the plan provision is not imposing a service requirement in violation of IRC 410(a)(1). Any employee that works 1,000 hours or more in an eligibility computation period would not meet the definition of a part-time or seasonal employee and thus would be eligible to participate.

Plan B should be challenged as the plan includes a provision that could impose a service requirement in violation of IRC 410(a)(1). The plan language provides that a part time or seasonal employee is one who **"is scheduled"** to work less than 1,000 hours of service. The plan provision could result in the improper exclusion of an employee who worked more than his **"scheduled"** hours of service.

Plan B would have to be amended to define the exclusion classification in such a way as to avoid imposing an indirect service requirement in violation of IRC 410(a)(1). Plan B could also be amended to include "fail-safe" language which provides that, notwithstanding any exclusion classifications, any employee that completes at least 1,000 hours of service in an eligibility computation period will be an eligible employee.

Example 2:

Plan C provides for one year of service as a condition of participation. Plan C also provides that employees classified as Hourly Paid Employees will be excluded from participation. The plan provides that Hourly Paid Employees are Employees that receive an hourly wage for their services.

Plan C should not be challenged, as the plan is not excluding Hourly Paid Employees based on an age or service requirement. The plan is providing for the exclusion of a class of employees based on their job classification.

If the plan defined Hourly Paid Employees as Employees that receive an hourly wage and whose customary employment is not more than 20 hours per week, the plan provision would not satisfy IRC 410 (a) or IT Reg. 1.410(a)-3(e) as the plan provision could result in the plan improperly excluding an employee who worked at least 1,000

hours of service in an eligibility computation period due to the fact that he worked more than his customary number of hours..

Plan C would have to be amended in the same manner as Plan B in Example 1.

Example 3:

Plan D provides for one year of service as a condition of participation. Plan D also provides that employees classified as Class B Employees will not be eligible to participate. Plan D does not define Class B Employees.

Plan D should be challenged to define Class B Employees and the definition should be scrutinized to determine if the class of employees is being excluded based on an age or service requirement that could be in violation of IRC 410(a)(1).

The applicant provides an amendment defining Class B employee as any employee who is a member of the substitute workforce of the Employer, as distinguished from regular full-time and part time employees, that is a separate employment classification based upon availability to work

Plan D, as amended, is now in compliance with IRC 410(a)(1) in form. The Class B exclusion classification is not based on a specified number of hours of service, but rather on the availability to work.